Economic Commentary

Speech by BOJ Deputy Governor Himino: Focus on structural upside risks to inflation

- Three obstacles to next rate hike
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FICC Research Dept.

Kento Minami
81-3-5555-8789
kento.minami@daiwa.co.jp

Kenji Yamamoto
81-3-5555-8784
kenji.yamamoto@daiwa.co.jp

Daiwa Securities Co. Ltd.

Three obstacles to next rate hike

Criticism is emerging from the business community that the BOJ is falling behind the curve in the face of high inflation driven mainly by food. However, we see three obstacles to its next rate hike: the need to assess (1) the impact of US tariff policy on the Japanese economy, (2) US economic conditions, and (3) domestic political developments.

While the US-Japan agreement was better than expected for the Japanese economy, tariffs are still having an impact: the Financial Statements Statistics of Corporations released on 1 September showed an 11.5% y/y decline in manufacturers' Apr-Jun recurring profit. We think the BOJ will need to at least carefully assess trends at companies following the US-Japan tariff agreement. July US employment data also showed a sharp decline in May-Jun as a result of retroactive revisions, signaling that the US labor market is clearly weakening. Given these circumstances, we think the BOJ will be carefully assessing Japan and US economic trends.

The BOJ will also need to assess domestic political trends. The LDP is scheduled to hold a post mortem on its poor Upper House election performance today (2 Sep.), and will decide on 8 September whether to move up the timing of its leadership election. At this point, our base case is for the LDP to maintain continuity with Ishiba's policies whether or not it brings forward the leadership election, and we see this as unlikely to impede rate hikes. However, we would watch the risk that the election outcome could result in market turmoil that forces the BOJ to push back its next hike.

Speech by BOJ's Himino: Focus on structural upside risks to inflation

Amid these conditions, BOJ Deputy Governor Ryozo Himino gave a speech in Hokkaido on 2 September. He noted in his speech that "the impact [of tariff policy] could be smaller or larger than expected. At the moment, the risk of a larger-than-expected impact may deserve greater attention." This is consistent with the view expressed in the July *Outlook for Economic Activity and Prices* report (*Outlook Report*) that there are substantial downside risks to the economic outlook.

Another focus in Mr. Himino's speech was the BOJ's changing view of underlying inflation. In his previous January speech, he noted that "where inflation expectations are not anchored at 2 percent, the central bank will consider how they could be anchored" and that "policy stance is set based on a judgment regarding underlying inflation." However, the Summary of Opinions from the July Monetary Policy Meeting (MPM) included the view that the focus of the BOJ's external communications should shift from underlying inflation to actual and forecast inflation, the output gap, and the forecast pace of inflation.

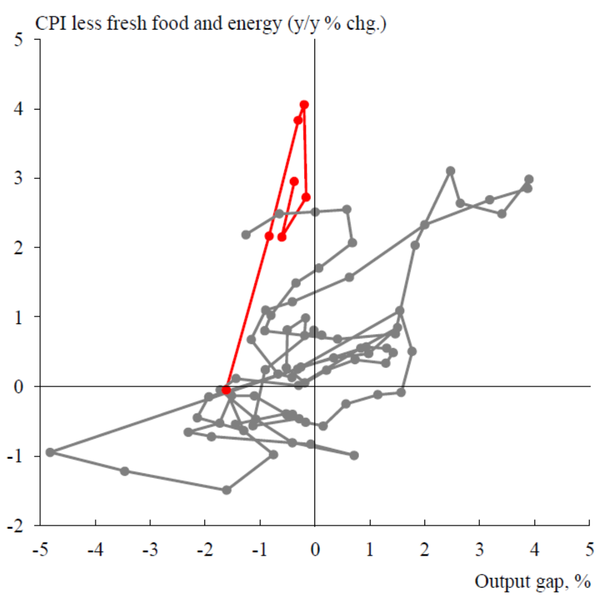
However, Mr. Himino noted that the uptrend in food prices will at some point slow and actual inflation will decline, resulting in underlying inflation that is broadly consistent with the BOJ's price stability target, and that underlying inflation "has recently approached 2 percent. That said, we do not yet consider it to have reached the 2 percent mark."

In short, the BOJ is signaling that it will continue to focus on underlying inflation (rather than high near-term inflation), despite the difficulty of conveying the concept in its external communications, until expectations are anchored at 2%. This underpins the BOJ's view that its current monetary policy conduct is not behind the curve.

However, the BOJ itself appears to be struggling to judge what is transitory and what is a change in underlying trend. Mr. Himino cited the following upside factors for underlying inflation in his speech: (1) labor shortages and evolving attitudes toward pricing among firms and consumers, and (2) changing global conditions, including deglobalization, worldwide labor shortages, and climate change. He also noted downward pressure on the Japanese and global economies from tariffs. As a result, he indicated the view that there are both upside and downside risks to inflation, consistent with the view expressed in the July *Outlook Report*.

We would note the differing nature of these upside and downside risks. Upside risks are structural, while downside risks are largely cyclical. For instance, the BOJ is focusing more on the structural drivers of above-forecast inflation, as evidenced by Mr. Himino's use of the Phillips Curve to explain that labor shortages tend to put upward pressure on wages and prices.

Output Gap and Prices



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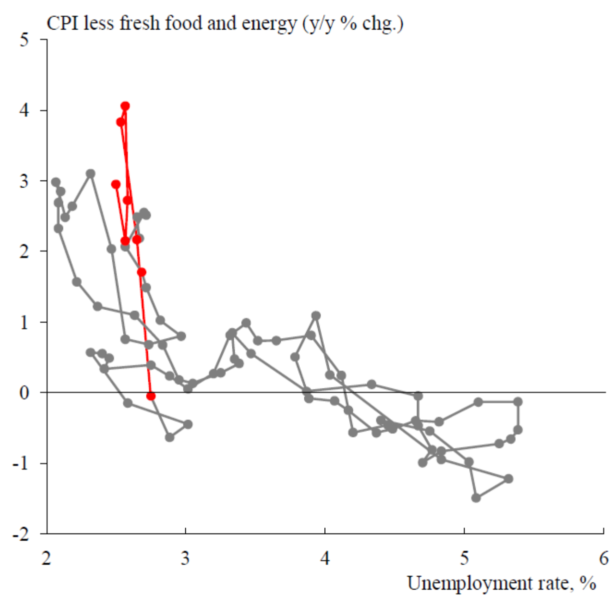
Unemployment and Prices



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Evaluating risk balance for monetary policy amid uncertainty

In his speech, Mr. Himino presented some remarks by New York Fed president John Williams, after which he noted regarding policymaking in uncertain conditions that "risk and uncertainty will never disappear from the landscape for policymakers" and that "we must continually assess the balance of risks, both upside and downside, and respond in a timely and appropriate manner to ensure that, even if conditions deviate from the baseline scenario, the damage is reasonably well contained." This is in line with the "risk management approach" advocated by Deputy Governor Shinichi Uchida on 23 July. In short, we think the BOJ is prioritizing orthodox policy conduct that adjusts the policy rate to a risk-neutral level amid uncertain conditions.

As we noted at the beginning of this report, the numerous obstacles to a rate hike make it difficult for the BOJ to strike too bullish a tone. However, going forward, it will need to confirm to what extent these hurdles ease from a risk-balance perspective, based on data mainly for Japan and the US.

Upside risks to underlying inflation (evolving corporate and consumer attitudes, changing global conditions) are largely structural, and while it is difficult to quantify their contribution at this point, we expect them to persist in the near term. However, we expect the impact of tariff policy (a downside risk to the economy and prices) to gradually diminish if the BOJ's October Tankan and branch manager's meeting confirm upbeat trends.

It will be difficult for the BOJ to fully grasp the impact of tariffs on Japan's economy and inflation by the time of the September MPM, so we would not expect a rate hike until at least October. However, the BOJ's growing focus on the risk of a structural inflation overshoot suggests that conditions are falling into place that would compel it to raise rates in Oct-Dec, without waiting for the outcome of the 2026 spring labor negotiations.

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